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SUBJECT: TRADE AND FINANCE EXPERTS SOUND THE ALARM

Summary

1. European trade and finance experts speaking at a December 18 HMG-sponsored conference in London spoke of an "acute crisis" in trade and finance that "puts world trade genuinely under threat." The credit crisis has administered two blows to world trade by: (1) decreasing economic activity and (2) by disrupting the system of trade finance and insurance that 80 to 90 percent of trade depends upon. They urged the UK government to make trade an important focus of its G20 presidency and urged international cooperation in propping up trade finance and insurance. End summary.

Trade is in Trouble

2. At a December 18th conference in London titled, "What world leaders must do to halt the spread of protectionism," academic economists and WTO staff (speaking in personal capacities) agreed that the \$12 trillion world trading system is already showing signs of distress and government action is required to prevent it from "collapsing."

3. Richard Portes (London Business School) and Richard Baldwin (Center for Economic Policy Research, CEPR) said that trade statistics and indicators are bleak. Recent figures show Chinese imports decreasing by 18 percent. The "Baltic Dry Index" which shows the cost of shipping goods is falling precipitously, an indicator of shrinking trade. Their international network of analysts believes that trade barriers are increasing as countries are beginning to try to protect domestic employment. Their conclusion is that international trade is heading towards a "radical and rapid fall."

4. Portes and Baldwin said that this crisis is unlike previous recessions because it is "not your usual capital account crisis"; the trade shock set off by the credit crisis is striking at manufacturing. The 2009 recession is going to be "sector specific" rather than with widespread, balanced, effects, making it difficult to deal with using traditional tools. The emerging markets cannot "ride out" this type of crisis and will have to resort to policies to stimulate exports, including competitive devaluations. Given that the alternative will be social unrest, it will be hard to persuade them to do otherwise. The U.S. Congress, they predicted, will not be passive in the face of cheapening imports and the international dialogue will sour. Congress is already "angry" with Chinese exchange rate policies; China is increasingly "angry" with the U.S. for having "mismanaged its economy." The atmosphere for cooperation in trade or climate change will be poisoned by the trade crisis.

5. Portes and Baldwin had three recommendations for the G20: (1) agree to use macro approaches to promote economic recovery, not trade restrictive measures; (2) wrap up the Doha modalities; and (3) ask the WTO and IMF to set up a surveillance mechanism to record protectionist measures.

They may be impossible to prevent, but at least keeping track of their introduction may make it easier to dismantle them quickly after the economy eventually improves, rather than having to painstakingly negotiate them away.

The Crisis in Trade Finance and Insurance

¶6. Marc Auboin of the Trade and Finance Division of the WTO told the conference, speaking "in a personal capacity" that it is very difficult to obtain reliable statistics on trade finance (the IFI's gave up trying in 2003) but it appears anecdotally that the cost of credit and insurance has tripled in the past few months -- for those companies that can obtain them. New customers have little chance of convincing increasingly conservative banks to assist them. Auboin estimated that in November 2008, \$25-30 billion in trade did not happen because the companies involved were unable to obtain credit or insurance. The situation is becoming worse.

¶7. Auboin said that part of the crisis is because over the past 10-15 years, an increasing amount of international trade was financed on an "open account" basis, meaning simply that traders were prepared to ship on the basis of a handshake -- without any formal credit or insurance at all. This has stopped cold because the companies' banks now demand formal assurances and protections. The credit and insurance markets are being overwhelmed by the demand for new (and old, such as letters of credit) financial instruments. Even for credit-worthy traders, the cost of the time it takes to arrange the credit and insurance instruments is a significant new burden -- a further drag on economic activity.

LONDON 00003196 002 OF 002

¶8. Trade finance has not received much attention in the past because it was considered one of the safest and most routine investments. This required a shared assumption that the flow of materials, parts, and support of major manufacturers could not be considered risky. Auboin said that if a globally-playing major manufacturer fails in the next few months, the global trade finance and insurance system could become paralyzed, with incalculable effects on world trade.

¶9. Auboin's advice to the G20 was that they initiate a coordinated effort to prop up trade finance and insurance -- through co-financing or risk-sharing. In the past, such steps would have been considered questionable trade subsidies "but no one is going to be litigious in the current crisis -- everyone knows they may have to do the same." The amount of money required would be modest because most trade financing remains objectively safe -- contrary to the bankers' fears. A more difficult question is what can be done to help countries such as Pakistan and Ukraine, which are rapidly becoming uncreditworthy. Because the elements that contribute to their lack of creditworthiness are difficult to untangle, it is difficult for the international community to know what specific actions can be taken to make them appear to be safe borrowers.

Comment

¶10. This conference was not the first time we've heard in London that the credit crisis is overshadowing an impending trade crisis. One of the speakers noted that the estimated annual benefits of a successful trade round are less than the financial markets have had wiped off their books on any one of several days in the past four months. However, trade will be key to the recovery, when it comes, and a round of protectionist measures would alarm world markets even more than they are already alarmed. As one of the speakers put it, "A new round of protectionism could turn a "V-shaped" recession into one that is "L-shaped."

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